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Setting the Sales Budget: An Exploratory Study

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SETTING THE SALES BUDGET: AN EXPLORATORY STUDY

Abstract

This article explores how the sales budget is set in a business organization. Findings from a longitudinal participant observation study revealed that the sales budget is considered of great importance to the organization as sales estimates serve as premises for planning of production and supply and new product developments. It was observed that the sales budget was based on a narrow, inner-directed perspective, almost looking away from important environmental driving forces such as competitors and customers. The findings also showed that individuals involved in the sales budgeting process behaved opportunistic, influencing the budgetary process and outcomes. Theoretical and normative implications are highlighted.

INTRODUCTION

This article examines how a business organization determines its sales budget. The sales budget is of utmost importance as it reflects expectations about future incomes and revenues, influencing organizational planning, resource allocation and coordination activities (Horngren 1984).

Organizations perform activities. Activities are the organizational "heartbeats" and they are costly. Due to resource dependency, organizations have to be effective, i.e., they have to perform activities appreciated by its clients and other constituencies, explained by Pfeffer and Salancik (1978) as: "The effectiveness of an organization is its ability to create acceptable outcomes and actions." Effectiveness represents "an external standard of how well an organization is meeting the demands of the various groups and organizations" (Pfeffer and Salancik 1978, p. 11). To business organizations customers play a predominant role. The main reason being for such organizations is their ability to attract and serve sufficient number of clients at prices at least covering costs. Sales budgets reflect serving organizations' expectations (and hopes) regarding their effectiveness in the marketplace.

Budgets

To allocate resources, coordinate internal activities and monitor external relationships organizations make use of plans, rules and procedures. Known to--and used by most organizations--are budgets. Several definitions of this term are offered throughout the budgeting

literature most of which emphasizing "plans," "activities," and "financial resources," e.g.: "... a comprehensive plan of operations and actions, expressed in financial terms" (Heiser, 1959, p. 3).

For an ongoing organization a budget reflects the past, as it is a statement of the future. Hence, budgets are plans reflecting predictions about future behaviors and outcomes. A budget reflects organizational aspirations, it may serve as a communication device for the organizational members (and others), and may have a signaling function as well (cf. Wildavsky 1986, pp. 7-9).

Behavioral Aspects of Budgeting

There is a vast literature on budgets and budgeting. A distinction may be made between the normative and the behavioral budgeting literature. In the normative literature the emphasis is on how to prepare and use budgets (cf. Horngren 1984). The human aspects of budgeting are by and large looked away from in the normative, but is extensively dealt with in the behavioral budgeting literature. The behavioral literature addresses questions such as: "How do budgets influence people?" as dealt with in Argyris' (1952) seminal study, who found budgets and budgeting related to several human relations problems, and the study by Hofstede (1967) exploring how budgeting affects managers and subordinates. The reversed question: "How do people influence budgeting?" has also been focused on in this literature (cf. Shift and Levin 1970). A variety of topics related to this question has been examined, such as the relationship between participation in budgeting and performance (cf. Brownell and McInnes 1986), the relationship between leadership style and budgeting (cf.

Chenhall 1986), how budgets are used to create organizational slack (cf. Merchand 1985; Onsi 1973), how resources are allocated (cf. Pondy and Birnberg 1969; Pondy 1970), and how resource allocation is influenced by political processes (cf. Pfeffer and Salancik 1974; Wildavsky 1979).

Most behavioral budgeting research has been conducted in the context of organizations "independent" of markets such as universities, hospitals and local governments, i.e., organiazations getting their main resources through lobbying and political processes directed towards public bureacracies (cf. Olsen 1970; Pfeffer and Salancik 1979; Wildavsky 1979).

The Sales Budget

For market-dependent organizations such as business firms (cf. Dill 1965) the flow of resources comes mainly from exchanges of organizational outputs in markets (cf. Thompson 1967). As resources are necessary for organizational survival and growth, the monitoring of market relationships is assumed being of crucial importance for such (market-dependent) organizations (cf. Kotler 1984).

Organizations often make use of many (several) budgets. In market-dependent organizations the sales budget plays a predominant role. When assumptions about the firm as portrayed in the situation of "pure competition" (i.e., complete information and resource mobility) are violated, preplanning and coordination become important to the firm. As total sales determine level of organizational activity and influence planning of production and supply, recruiting and training

of personnel, it is no wonder why the importance of sales budgets is emphasized (cf. Horngren 1984).

Any sales budget rests on some prediction of future sales. The normative budgeting literature recognizes difficulties in predicting sales. Various techniques and methods to cope with these difficulties have been proposed (see Kotler 1984, chap. 7 for overview). The behavioral aspects, i.e., how organizational members cope with these difficulties and influence the sales budget are overlooked in this (the normative) literature. The behavioral-oriented budgeting literature has only indirectly treated this question in focusing on setting of standards and on how organizational and interpersonal variables may influence participation in budgeting (for overview of findings see Brownell 1982).

Conceptual Framework

Even in situations where a priori knowledge is modest--as in the present case--the researcher holds assumptions and "hunches" that will guide his or her inquiry. By taking such assumptions and "hunches" directly into account also exploratory research may benefit from a priori theorizing (Zaltman et al. 1982).

In market-dependent organiztions (i.e., business firms) the individual members in most cases are full-time participants. They are members to provide livelihood, and will often demonstrate career commitments (cf. Dill 1965). Moreover, most business organizations are action oriented, assumed watching market relationships as the monitoring of such relationships determines organizational outcomes and opportunities for its members. Thus, it seems reasonable to assume that

members of such organizations are better informed and more devoted to organizational tasks than are part-time members in bureaucratic, non-market organizations as reported on in most previous budgetary studies (cf. March and Olsen 1976).

Organization members occupy various positions. Positions are related to opportunities and obligations. The normative budgetary literature assumes (cf. Horngren 1984)--as documented in the behavioral literature--that budgeting primarily is a top- and middle-management task (for overview see Brownell 1982). The tasks to be budgeted such as sales may, however, influence the various organizational members differently.

Organizational members may be conceived as agents contracted to perform various tasks (cf. Pratt and Zeckhauser 1985). Often the agent is assumed to know more about the task to be performed than does the principal. Moreover, the agent is assumed to behave opportunistic (cf. Williamson 1979) within the limits imposed on her or him by being an organization member (cf. March and Simon 1958, p. 90). Thus organization members participating in budgetary activities are assumed to take both organizational and individual goals into account (cf. Williamson 1964). Based on the above discussion, we will introduce the conceptual framework as shown in Figure 1.

Insert Figure 1 about here

Figure 1 is to be read as follows: Organizational factors such as mode of supervision, structure, rules and procedures, past experiences, goals and expectations (1) will influence participation in budgeting,

how the budgetary process proceeds (3) and the outcome of this process (4). Various individual factors such as position in the organization, knowledge, goals and expectations of participants will, however, modify budgeting activities and outcomes (2). As the budgetary process proceeds, information and estimates will be submitted ana modified (3), resulting in the final sales budget (4).

CASE: ALPHA[1]

The Company

The Alpha Company (Ltd.) is a division in the Beta Corporation situated in a larger city on the western coast of Norway. The company was founded in the mid-fifties and enjoyed rapid growth during the first decades. The main products are various types (product groups) of flooring materials of plastics. Efficient use of the firm's production technology requires considerable amount of pre-planning and lead-time. At the domestic market the Alpha company holds high market shares within this specific product category (i.e., flooring materials of plastic). A considerable fraction of the company's production is exported, in particular to other Nordic countries. The last ten years the sales growth has slowed down, and when the research was conducted, realized sales were approximately 20 percent below budgeted sales.

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[1] The case description is based on longitudinal participant observations. The observations were conducted by one of the authors when formally hired for four months to work as accountant/economic consultant with the Alpha Company. The real purpose approved by Beta's top management was, however, to study the company's budgeting system and procedures. The observer had access to budget meetings and relevant documents, such as budget memos, letters, reports and plans. A detailed diary was kept covering the various events and observations. The observations were continuously interpreted and reinterpreted during the period of observation (Glaser and Strauss 1967).

Management/Organization

Alpha is headed by a MBA-educated manager (M) who was assigned the top position in Alpha after working a few years as the company's marketing manager. In addition to the top manager (M), the production (P) and marketing (MKT) manager constitute Alpha's top-management.

The marketing function is organized as a product management organization (cf. Kotler 1984), where each product group is headed by a product manager. Two sales managers (S) are in charge of the sales force, one for each of two regions. They are both reporting to the marketing manager. Alpha is perceived as important for the Beta corporation. The vice president (VPB)--who is the informal leader--and the financial officer (FO) in the Beta corporation are involved in budgeting and other activities taking place in Alpha.

Setting the Sales Budget

A memo from the financial officer dated August 17 started "this year's" sales budgeting process, resulting in a sales budget which was turned down by the price authorities due to proposed increases in prices[2] October 19. The sales budget was modified and finally settled by October 21. Events and participants are listed in Figure 2.

Insert Figure 2 about here

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[2]All proposed increases in prices by business firms have to be approved by the price authority in this country. This rule was introduced several years ago as a device to control prices and keep down rate of inflation.

ANALYSES[3]

In the following we will emphasize both organizational and interpersonal factors. Numbers in parentheses refer to events listed in Figure 2 (cf. left column).

Inspection of Figure 2 shows that Alpha posesses programs that initiate as well as modify the budgeting process. Inspection of the start of the budgeting process, the memo from the financial officer (1) shows according to Starbuck (1983), that programs in Alpha "generate actions." Or, in the words of Wilensky (1967), the Alpha organization has "intelligence" that initiates and modifies the budgeting process.

An interesting additional observation is the long delay between the first signal (1) and the following request for sales estimates (2) indicating that Alpha partly is functioning in a "reactive" way, and that time pressure is needed to bring a task on the organizational members' agenda as proposed by March and Simon (1958).

The reported data show, as assumed at the outset of this article, that budgeting sales <u>is</u> of importance to the firm. Additional data (not reported in Table 2) also show that estimates from the sales budget serve as premises for planning of supply and production, and decisions regarding new products/product modifications as well.

Inspection of Table 2 demonstrates that the various activities are primarily related to problems/questions regarding prices and volumes.

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[3]The present analysis may be seen as reanalysis or "sense-making" of previous observations (cf. footnote 1); i.e., the prime purposes are interpretation and understanding (cf. Chua 1986).

According to the case description, the market situation of Alpha can be classified as oligopolistic. Inspection of the budgetary process shows that some price reactions are assumed (15). It is, however, evident that participants in the budgetary process are confronted with high perceived uncertainty when it comes to "estimating" price-volume relationships (9). An interesting observation is that they (the participants in the budgeting process) in fact do not try to estimate price-volume relationships, but that they rather are trying to arrive at some "quesstimate" for prices and volumes separately!

It was initially assumed that participants involved in sales budgeting would closely watch customers and competitors as basis for monitoring of sales-market relationships. Inspection of the budgetary process shows this not to be the case. In fact, Figure 2 reflects that modest--almost no attention at all is directed towards competitors or customers. Inspection of reports and plans (cf. footnote 1) showed that some rough estimates of future sales had been made, mainly based on crude economic indicators such as projected growth in income per capita and future trends for the building industry. Indicators representing "driving" forces in Alpha's market environments of importance for its survival and growth, such as consumer needs, competitors and their actions (cf. Porter 1980) were not directly focused on by the sales budget participants.

This may be interpreted as the management of Alpha has constructed some reality (cf. Berger and Luckman 1966), and that yesterday's reality constructions represent the "glasses" of tomorrow. This is in no way a new phenomenon. Levitt (1960) in his seminal article,

"Marketing Myopia" has showed how whole industries have disappeared due to inability to "discover" crucial environmental changes taking place. The findings show that organizations do not always seek information when needed nor that they use information possessed, and that information may be used inadequately as well (cf. Feldman and March 1981).

The reported findings do also show that budgeting has a "human" side (cf. Argyris 1952; Schiff and Lewin 1970). For example, in negotiations on volumes (7) additional information was supplied to "allow" the counterpart to modify his estimates and get redress as described by Goffman in his recognized contribution, "On Cooling the Mark Out" (1952).

The present case also shows that coercive power might be used in budgeting (cf. (4)), where relative organizational position represents the power base. The case description, however, also demonstrates that organization members may oppose (3).

Inspection of price and volume estimates for the manager (M) and the marketing manager (MRT) in Alpha is noteworthy. Why is it so that the manager wants to escalate the price and volume estimates while the marketing manager wants to lower these estimates? Several explanations may be offered. As noted at the outset, employees are agents. The marketing manager is an agent of Alpha's manager, as the manager (M) is an agent to Beta's top management. The manager (M) has to perform, but as shown in the above case description, realized sales are lagging approximately 20 percent behind budgeted sales. Thus, he (M) is trying to "buy" time; he has to demonstrate that he believes in the company as he has to show that he believes in what he is doing. The potential

confrontation with sales budget deficits may later on be "explained" by "unexpected" events such as entrance of new competitors or competitors' use of dumping prices (cf. (15)). It might also be so that the manager (M) perceives high budget estimates as a motivational factor. Unfortunately the information available is insufficient to pursue this question to arrive at a final explanation.

For the marketing manager, however, the sales budget represents an obligation. To him a potential sales budget deficit represents a substantially higher personal cost. A budget deficit will show that he has "not performed well," while budget surplus might be interpreted as "excellent performance." To him the sales budget represents the performance standard according to which he is perceiving himself being evaluated.

CONCLUDING REMARKS

One swallow does not make the summer, neither does one intensive case study represent the whole truth. Some preliminary conclusions may, however, be drawn from this study. The present study corroborates what is assumed in the normative budgeting literature, and "what every managers know," that the sales budget is important to business organizations. The findings also suggest that organizations "construct" biased images of their environments heavily influenced by past behavior and previous expectations as reflected in recent organizational literature based on social cognition theories (cf. Kiesler and Sproull, 1982, for overview), and that such socially constructed images may influence sales budgeting behavior as well. The reported results do also indicate as proposed by Schiff and Lewin (1970) that people may influence

budgets. Moreover, the findings suggest that individuals involved in organizational budgeting exhibit opportunistic behavior taking their own interests into account to the extent this is perceived manageable whithin the organizational context (contract). Lastly, the findings from the present study conducted in a market-dependent business organization suggest that the individual's dependence on the organization influences the person's attention towards budgeting activities and how the budget may impact her or him substantially more than reflected in past behavioral budgetary studies conducted in bureaucratic, non-market organizations. In these studies the consequences for persons involved (in the budgetary process) have often been negligible (cf. March and Olsen 1976), or the consequences may be played down as reported in a recent study by Larkey and Smith (1984) who found government budgets to be misinterpreted, and that "... they (the participants) explain their budget formulations in ways that absolve them of most of their responsibility" (p. 80).

The findings have normative implications as well. The fact that organizations construct their--often biased--environments is of importance for the quality and usefulness of the organization's sales budget. As budgeted sales guide level of activity and planning of supply and production, efforts should be done so that predicted organizational performance should be reflected realistically in sales budgets. This calls for increased emphasis on "problem finding" (cf. Dillon 1982) in order to construct relevant environmental images to "see" opportunities and threats, to better positioning the organization so it can perform

its best, as well as making the sales budget a relevant management tool.

The reported findings show that people may influence budgets, but relatively little is known how and by whom budgets are influenced. Research is needed to assess such influences to refine budgeting theory as basis for improving budgeting practice.

Our findings also show that organizational members exhibit opportunistic behavior, which have implications for design of incentive structures. The relationships between incentives and budgets are important and should be considered to make budgets what they are supposed to be, i.e., useful management tools.

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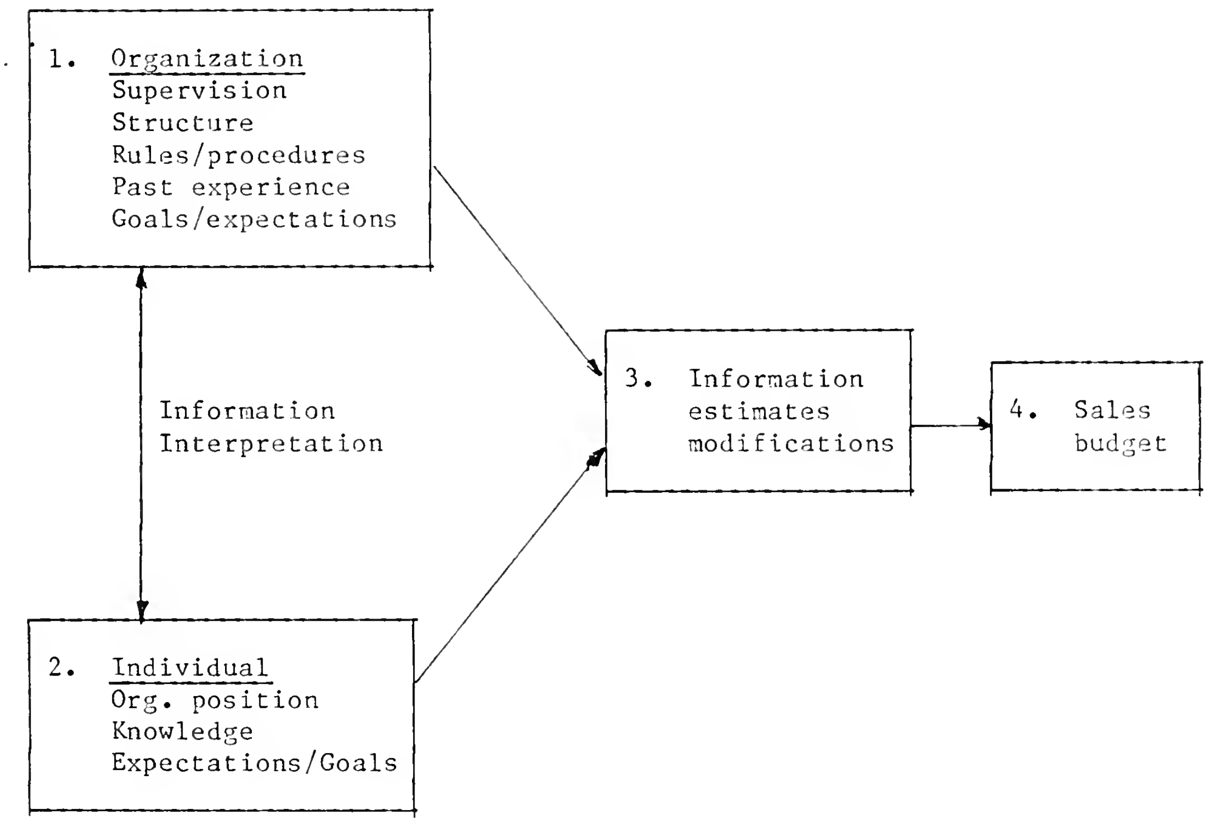

Figure 1. Conceptual Framework

No.	Date	Event	Present/ Receiver	Content/Observation
(1)	8/17	Budget memo (I) from FO	M, P	Reminder. Proposal for master budget for Beta. Due by middle of October, implying that estimates for sales and and contributions must be proposed by end of September.
(2)	9/15	Request from FO	M, MKT	Estimates for expected sales for the major products needed.
(3)	9/15	Reply from MKT	FO, M	Too early. M denies to give estimates of sales volumes before attending the product meeting* next week. *Group meeting where representatives from sales, marketing, production and top management discuss assortment, product developments, design and market expectations.
(4)	9/22	Command from VPB	M, MKT	VPB orders that the sales organization shall be involved in the sales budgeting process.** **Due to the sales deficit, the sales managers were not invited to participate in the budgeting of sales by M.
(5)	9/28	Budget memo II from FO	M, MKT, P and other	Preliminary budgets due by October 6 to be discussed and modified by a committee covering all of Beta's companies October 10, and final budget not later than October 20. Only known or planned changes in costs and prices should be included in the budget.
(6)	9/28	Meeting	M, MKT, P	MKT proposes sales volumes. The proposal is perceived as too low and turned down.
(7)	9/28	Meeting	M, MKT	Budget for sales costs discussed and agreed upon.

				Volume negotiations. P adds and MKT reduces the volume estimates.
(8)	9/30	Meeting	M	Negative reactions from M. "The volume estimates are much lower than last year's budget." "If this is the reality we have to lay off 10 employees. We have to do something with this."
(9)	10/6	Meeting	MKT, P	Prices are discussed. Realized prices used as baseline. However, uncertainty regarding basic information for making the price budgeting decisions prevails. Various procedures for estimating prices are discussed. M emphasizes the need for not overestimating the prices.
(10)	10/11	Meeting	MKT, Sales Managaers, Sales Representatives	MKT presents proposed product changes and ask sales managers for sales estimates by 10/17.
(11)	10/17	Meeting	FO, M, MKT, P	FO raises the budgeted prices, but they are modestly reduced in the following discussion.
(12)	10/17	Meeting	VPB, M, MKT	The volume estimates supplied by the sales organizations and marketing department are compared. Volume estimates are increased.
(13)	10/19	Revision by P		The prices suggested 10/17 are raised.
(14)	10/19	Meeting	VPB, M, FO	Negative reaction from the price authorities. Decide to present two new budget alternatives to the price authorities.

(15) 10/12	Post-hoc comments from M	"The budgeted prices are the lowest we will obtain in the market... Due to economic conditions, and observed tendencies to dumping, no increase in volume, except for product X, is budgeted."

M = Manager
MKT = Marketing Manager
P = Production Manager in Alpha
VPB = Vice President
FO = Financial Officer in Beta

Figure 2. Events and Actors in the Sales Budgeting Process